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INTRODUCTION

In accordance with the City Auditor's 1996-97 Audit Workplan, we are auditing the Integrated Waste Management services the Environmental Services Department (ESD) provides. Included in our audit of ESD is a review of the fees that commercial solid waste haulers and waste generators pay. Because of budget implications, we are presenting this portion of our review separately. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

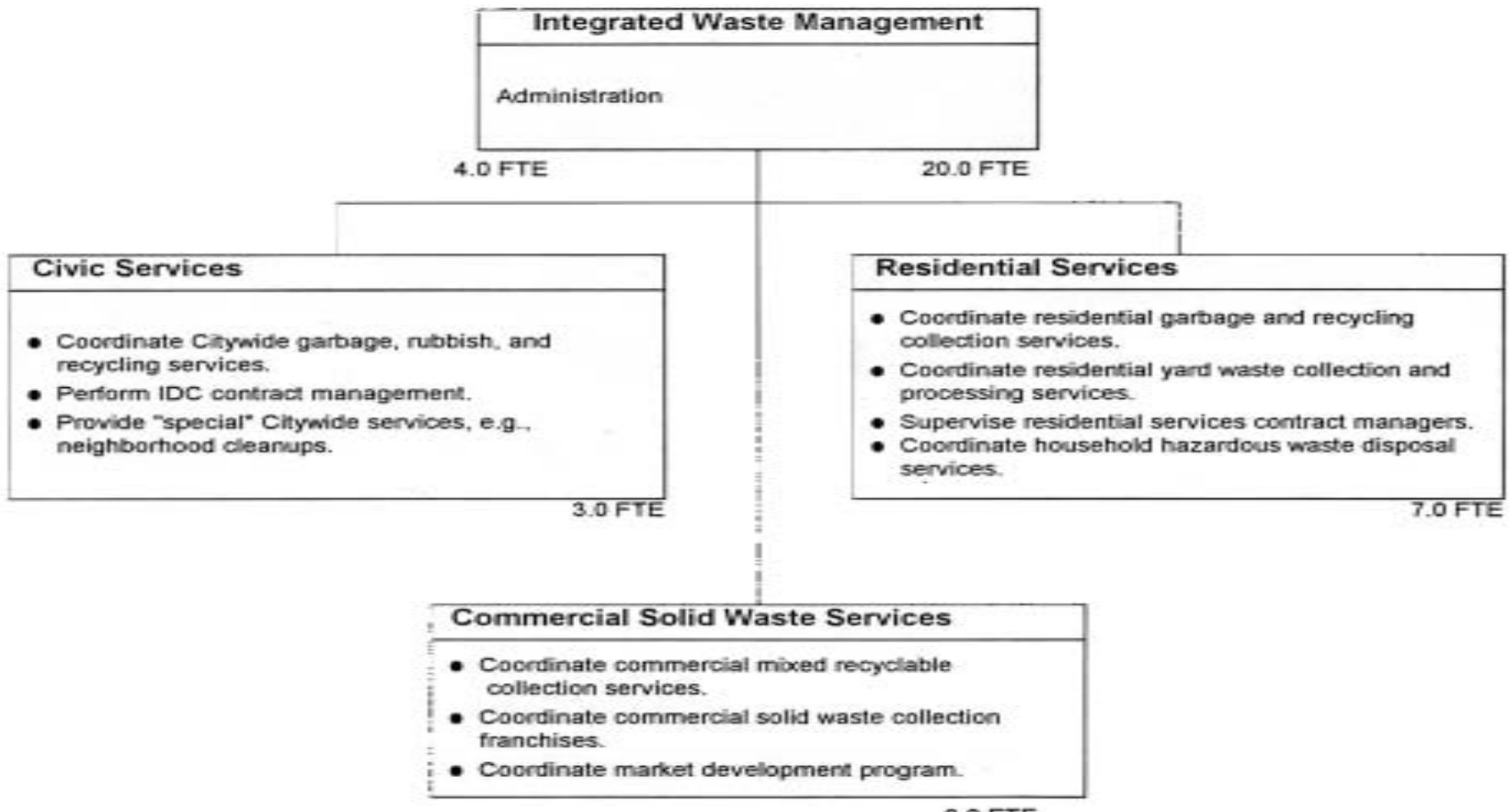
The City Auditor's Office thanks the Integrated Waste Management division of the ESD for their time, information, insight and cooperation during the audit.

BACKGROUND

The Integrated Waste Management division (IWM) of the Environmental Services Department administers residential garbage and recycling collection services, residential yard waste collection and processing services, household hazardous waste disposal services, commercial solid waste and recyclable collection franchise activities, the City of San Jose's landfill contract, a market development program, and Citywide solid waste collection services. The IWM Fund (Fund 423), and to a lesser extent the General Fund, fund these activities. There are 20 FTE assigned to the program.

As shown in Chart 1, IWM is organized in four sections: Administration, Civic Services, Commercial Solid Waste Services, and Residential Services.

INTEGRATED WASTE MANAGEMENT ORGANIZATION CHART



SCOPE AND METHODOLOGY

The objective of our review of the City of San Jose's commercial solid waste (CSW) fee structure was to assess the impact of 1996-97 changes to those rates. We met with staff of the Integrated Waste Management (IWM) division of the Environmental Services Department, Treasury, and the Budget Office. We reviewed and compared the haulers' remittance and activity reports to the IWM internal database and the City's Financial Management System. We interviewed staff, reviewed council memoranda, and reviewed the method that IWM used to recalculate the 1996-97 rates.

We performed limited testing to determine the accuracy and reliability of information in the various computer reports we used during our audit. We did not review the general and specific application controls for the computer systems used in compiling the various computer reports we reviewed.

FINDING I

NEEDED MODIFICATIONS TO COMMERCIAL SOLID WASTE FRANCHISE AND SOURCE REDUCTION AND RECYCLING FEES WOULD INCREASE GENERAL FUND REVENUES BY \$1.4 MILLION TO \$2.8 MILLION, AND INCREASE INTEGRATED WASTE MANAGEMENT FUND REVENUES BY \$0.5 MILLION

In July 1996, the City of San Jose (City) changed its method of charging commercial solid waste (CSW) franchise, and source reduction and recycling (AB 939) fees, from a gross receipts basis to a volume basis. However, our review revealed that the ESD miscalculated the rates necessary to achieve the adopted 1996-97 budget. Although these foregone revenues have been partially offset by \$1.5 million in one-time carryover revenues from 1995-96, we estimate that the General Fund and the Integrated Waste Management (IWM) Fund will forego approximately \$1.4 million and \$0.6 million, respectively, in 1996-97. In our opinion, in order to avoid similar foregone revenues in 1997-98, the Administration should propose a rate structure that will maintain the revenue base with regards to franchise fees. In addition, the Administration should propose a rate structure that will produce the amount of AB 939 revenues shown in the 1997-98 Fees and Charges Report. We estimate this would increase 1997-98 General Fund and IWM Fund revenues by approximately \$1.4 million and \$0.5 million, respectively. In addition, we recommend the City Council consider assessing additional fees to recover the \$1.4 million in foregone 1996-97 General Fund revenues. As a result of these changes, we estimate that the General Fund could realize an additional \$1.4 million to \$2.8 million, and the IWM Fund could realize an additional \$0.5 million in 1997-98.

City Fees On Commercial Solid Waste Haulers And Generators

Prior to 1995, the City franchised one hauler on an exclusive basis for commercial garbage collection services. The City Council set the customer rates. The City also franchised rubbish collection services on a non-exclusive basis and reviewed the rates the haulers charged their customers. Beginning in January 1995, the City merged the garbage and rubbish franchise

into an integrated free market CSW franchise system. CSW franchises were granted on a non-exclusive basis, and franchisees were allowed to set their own customer fees without City review or approval.

CSW haulers remit monthly franchise fees to the City's General Fund for the privilege of doing business in the City. For 1995-96, the CSW franchise fee was 28.28 percent of a hauler's gross receipts in excess of \$250,000. According to the City's Financial Management System (FMS), General Fund revenues from CSW franchise fees totaled \$7.9 million in 1995-96. For 1996-97, IWM changed to a volume-based franchise fee of \$1.64 per cubic yard in excess of 43,000 cubic yards per year. It should be noted that the volume-based fee is calculated on bin capacity times the number of collections -- not the amount that is actually hauled away. As of May 1997, IWM and the Budget Office estimate that 1996-97 General Fund revenues from CSW franchise fees will be \$6.85 million.

CSW haulers also remit monthly CSW AB 939 fees to the IWM Fund. The California Integrated Waste Management Act of 1989 (commonly known as AB 939) required cities and counties to prepare, adopt, and implement source reduction and recycling plans, and authorized them to collect fees to cover their costs in doing so. For 1995-96, the City's CSW AB 939 fee was 30 percent of gross receipts which the waste generators paid. For 1996-97, the City also changed this fee to a volume basis of \$1.77 per cubic yard collected. Although the haulers remit the AB 939 fees to the IWM Fund, the garbage and rubbish generators are actually responsible for paying for waste reduction and recycling programs. The structure of both the CSW fee and the AB 939 fee is designed to act as a financial incentive to encourage San Jose businesses to recycle and reduce their solid waste. According to the FMS, \$8.0 million in CSW AB 939 revenues went to the IWM Fund in 1995-96. As of May 1997, IWM and the Budget Office estimate that \$8.0 million in AB 939 revenues will go to the IWM Fund in 1996-97.

Haulers remit both types of CSW fees to the Treasury Division of the Finance

Department. A sample of the 1995-96 Fee Remittance Report is attached as Appendix B, and a sample of the 1996-97 Fee Remittance Report is attached as Appendix C.

Table 1 shows the changes in CSW franchise and AB 939 rates from 1993-94 through 1996-97.

TABLE 1
COMMERCIAL SOLID WASTE RATES
1993-94 THROUGH 1996-97

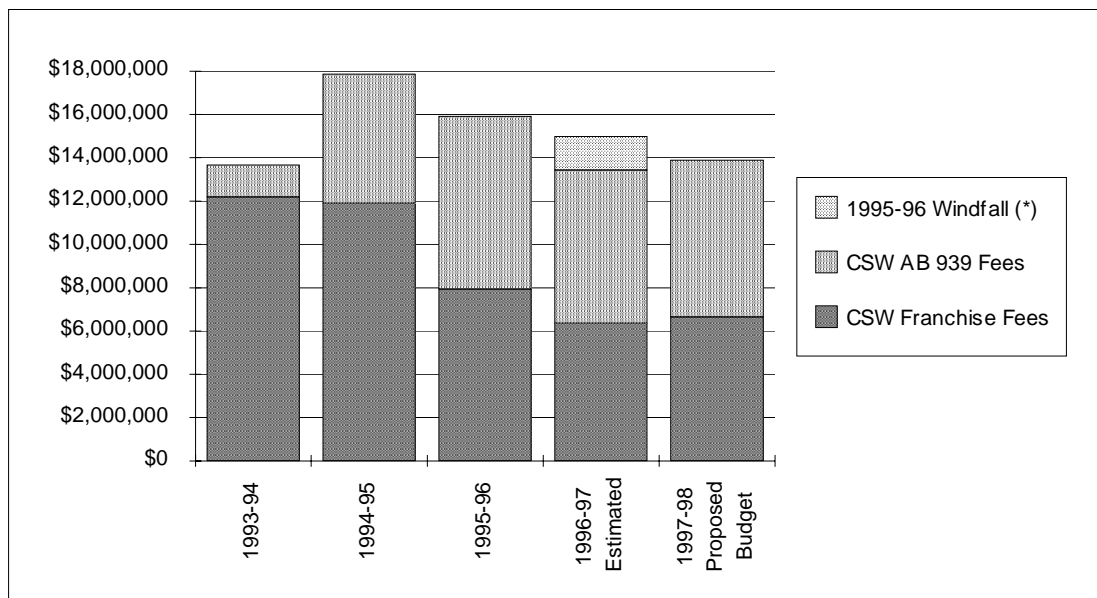
	1993-94	1994-95	1995-96	1996-97
CSW Franchise Fees	Garbage: \$4.58 per CY (\$22.11 per CY for compacted garbage) Rubbish: 10% of GR <\$100,000, 20% of GR >\$100,000, 30% of GR >\$250,000	Garbage: \$4.58 per CY (\$25.92 per CY for compacted garbage) Rubbish: 28.28% of GR >\$250,000 (effective 10/94)	Solid Waste: 28.28% of GR >\$250,000	Solid Waste: \$1.64 per CY >43,000 CY (Compacted yardage multiplied by 3)
CSW AB 939 Fees	Garbage: \$1.20 per CY Rubbish: 0%	Garbage: \$1.20 per CY Rubbish: 30% of GR (effective 10/94)	Solid Waste: 30% of GR	Solid Waste: \$1.77 per CY (Compacted yardage multiplied by 3)

NOTE: **GR** = gross revenue; **CY** = cubic yards

As a result of the above changes in the CSW fee structure, CSW franchise and AB 939 fee remittances have varied over the last five years. Graph 1 shows the total of both fees from 1993-94 through 1997-98 (budgeted).

GRAPH 1

COMMERCIAL SOLID WASTE FRANCHISE FEES AND AB 939 FEES 1993-94 THROUGH 1997-98



(*) The 1995-96 windfall is described on page 12 of this report.

The 1996-97 Change From Revenue-Based Fees To Volume-Based Fees Was Supposed To Maintain The Revenue Base

As of July 1, 1996, the City went from a revenue-based to a volume-based CSW franchise fee structure. According to the ESD, changes to the CSW program were necessary in order to close a loophole associated with the pricing structures commercial haulers implemented at the City's expense. Specifically, since City fees were based on gross receipts and recyclable collections were exempt from City fees, haulers had an incentive to minimize solid waste collection charges and maximize recycling collection charges. Table 2 illustrates a simple structuring of hauler charges to its customers that would effectively result in the avoidance of City fees.

TABLE 2

**HYPOTHETICAL EXAMPLE OF A HAULER STRUCTURING
ITS CUSTOMER'S COMMERCIAL SOLID WASTE CHARGES
TO AVOID PAYMENT OF CITY FEES**

	Normal Fee	Structured Fee To Avoid Payment Of City Fees
Customer Hauling Charges:		
CSW hauling charge	\$100.00	\$ 0.00
Recyclable hauling charge	<u>25.00</u>	<u>125.00</u>
Subtotal	\$125.00	\$125.00
City Fees:		
AB 939 fee (30% of CSW charge)	\$ 30.00	\$ 0.00
Franchise fee (28.28% of CSW charge)	<u>28.28</u>	<u>0.00</u>
Subtotal	\$ 58.28	\$ 0.00
Total Fees and Charges	\$183.28	\$125.00

As shown above, the structured fee would not only reduce City revenues, but would give an unfair competitive advantage to a hauler who used this scheme to underbid its competitors.

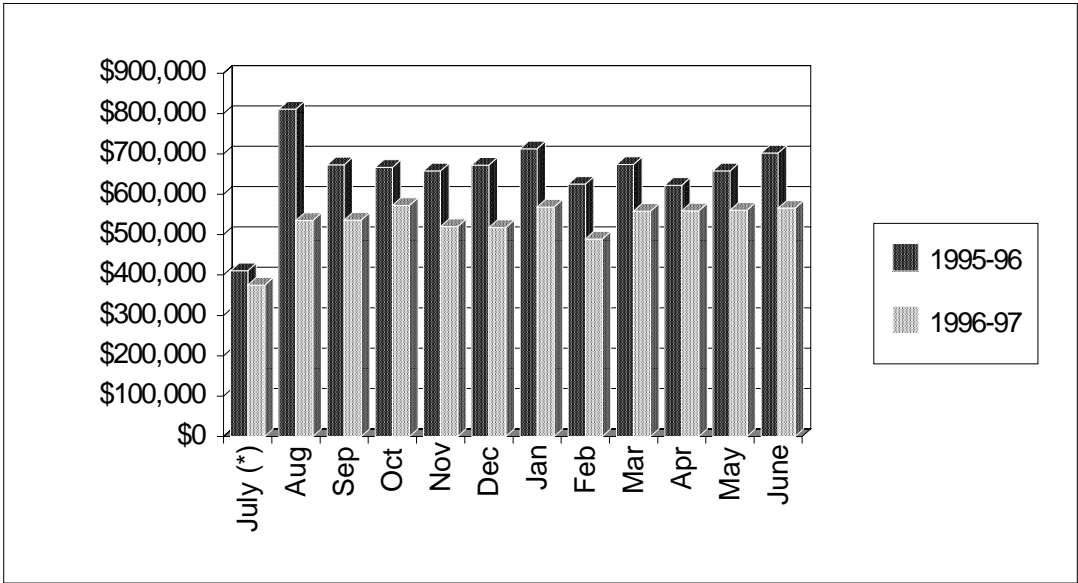
The July 1, 1996, Franchise Fee revision was "*projected to maintain a FY 1996-97 franchise fee revenue base of \$7,875,000, assuming current service levels.*" According to the ESD and the Budget Office, the only change in franchise fee budget projections from 1995-96 to 1996-97 was due to expectations of reduced volume of solid waste collected. The July 1, 1996, AB 939 Fee revision that was proposed in the Fees and Charges Report was projected to generate \$7.5 million. The change from a revenue-based to a volume-based remittance system for both Franchise Fees and AB 939 Fees was designed to prevent a pricing scheme such as shown in Table 2 and was supposed to maintain the revenue base for franchise fees and produce the AB 939 revenues shown in the Fees and Charges Report.

**ESD Miscalculated The Rates Necessary
To Maintain The Revenue Base**

The IWM division of the ESD was responsible for estimating and proposing the revised 1996-97 rates. However, by October 1996, it became clear that 1996-97 revenues would be significantly below budget projections. Graph 2 shows the drop in monthly franchise fee remittances before and after the volume-based system was implemented.

GRAPH 2

**COMPARISON OF MONTHLY CSW FRANCHISE FEE REMITTANCES
BEFORE AND AFTER THE RATE CHANGE
(NOT INCLUDING ONE-TIME CARRYOVER REVENUE)**



(*) Annual exclusion taken in July.

By February 1997, the 1996-97 Mid-Year Operating Budget Review projected a significant CSW Franchise Fee revenue shortfall by year-end. Specifically,

Collections to date from Commercial Solid Waste Franchise Fees are tracking significantly below projected levels and may be as much as \$825,000 (10.5%) below budgeted estimates by year-end. Effective July 1, a new rate structure for these fees (based on volume rather than gross receipts) was introduced with the goal of closing loopholes in the old rate system. In setting the new rates, it appears that data used by the Environmental Services Department for

estimating what volume of waste would be produced based on historical tonnages was inaccurate and the impact of the 43,000 cubic yard exemption per hauler was calculated incorrectly. As a result, volume has fallen short of projections. Other factors which are contributing to the shortfall include an increased waste diversion rate in the commercial sector and an increase in the number of small haulers involved in construction and demolition recycling. Both of these factors have reduced the total commercial tonnage subject to the franchise fee. Staff from the Environmental Services Department are examining the situation and are considering proposing a rate increase in the future to bring receipts closer to historical levels.

Although our review confirms that there may be a drop in volume hauled from 1995-96 to 1996-97 (from 4,217,000 to 4,142,000 cubic yards), this is not a significant factor in the projected franchise revenue shortfall. Specifically, assuming a \$1.64 franchise fee per cubic yard, a 75,000 cubic yard decrease would decrease revenues by only \$123,000.

The drop in CSW franchise fees was the result of a miscalculation of the new rate structure needed to maintain the revenue base and achieve the revenues shown in the Fees and Charges Report. There are several possible reasons for the miscalculation of the revised rates. First, according to IWM, staff only used one month of data in its analysis. The problem with using only one month's worth of data is that monthly remittances fluctuate as shown in Graph 2. Second, according to IWM, staff only used bin capacity data it specifically requested from the four largest haulers in its analysis. In retrospect, specific bin size data was not necessary because IWM already had a year's worth of volume information. Third, ESD's new volume-based system was supposed to use a conversion factor of three times the volume for compacted material. IWM was not consistent in using the conversion factor when calculating the new rate. Fourth, there was an error in a formula that IWM used to calculate equivalent volume. It should be noted that even after factoring in the above four reasons, we are unable to reconstruct how ESD calculated the rates for 1996-97.

\$1.5 Million Windfall Has Offset The 1996-97 Shortfall

Our review indicates that \$1.5 million in one-time carryover revenue from 1995-96 has offset the 1996-97 shortfall. Specifically, we found that haulers have remitted \$402,000 in CSW franchise fees and \$1,142,000 in CSW AB 939 fees for 1995-96 hauling activities that their customers did not pay for until 1996-97. These one-time revenues are the result of changing from a revenue-based to a volume-based fee structure, and a change in when CSW activities are subject to fees. Under the revenue-based fee structure, haulers paid CSW franchise fees and CSW AB 939 fees based upon customer payments received during the month-- regardless of when the hauler provided the service. Under the new volume-based fee structure, haulers remit CSW franchise fees and CSW AB 939 fees based upon the period the hauler provided service -- regardless of when the customer actually pays the hauler. As a result, the City received a windfall to the extent a hauler paid its CSW franchise fees and CSW AB 939 fees based upon both customer payments for pre-1996-97 services and 1996-97 hauling activities. This one-time windfall has obscured the amount of the 1996-97 shortfall.

\$2.1 Million In Foregone Revenue For 1996-97

The 1996-97 Adopted Budget was \$7.9 million in CSW Franchise Fees and \$7.5 million in CSW AB 939 Fees. Projected net revenues for 1996-97 are \$6.4 million in Franchise Fees and \$6.9 million in CSW AB 939 Fees. When compared to expected net revenue for 1996-97 (net of the one-time windfall), we estimate that the rate miscalculation will cost the City nearly \$2.1 million in 1996-97 -- \$1.4 million in the General Fund and \$0.6 million in the IWM Fund. Table 3 shows this calculation.

TABLE 3

ESTIMATED 1996-97 FOREGONE REVENUE

	CSW Franchise Fees	CSW AB 939 Fees	Total
1996-97 Adopted Budget	\$7,875,000	\$7,500,000	\$15,375,000
Expected Net Revenue for 1996-97			
Projected 1996-97 revenue	\$6,850,000	\$8,000,000	\$14,850,000
Less One-time Windfall (Page 12)	(402,309)	(1,142,397)	(1,544,706)
Projected net revenue for 1996-97	\$6,447,691	\$6,857,603	\$13,305,294
Estimated 1996-97 Foregone Revenues	\$1,427,309	\$642,397	\$2,069,706

**Corrected Rates Would Generate
An Additional \$1.9 Million In 1997-98**

The Administration will be bringing forward recommendations for revising CSW fee rates in Fall 1997. According to the 1997-98 Proposed Operating Budget,

Because of [the] dramatic and unexpected fall-off in revenues from the imposition of the new rate structure, staff in the Environmental Services Department are currently exploring the possibility of revising the rate structure for 1997-98. Recommendations are anticipated to be brought forward in September 1997.

In our opinion, the Budget Office and ESD should propose revised CSW Franchise Fee rates for 1997-98 that maintain the revenue base for franchise fees as compared to the 1996-97 Adopted Budget. In addition, the Budget Office and ESD should prepare CSW AB 939 rates for 1997-98 that will produce the revenues shown in the 1997-98 Fee and Charges Report. We estimate this would require a CSW Franchise Fee rate increase of 22 percent and a CSW AB 939 fee increase of 7 percent. Absent a rate change, we estimate the General Fund will forego \$1.4 million in CSW Franchise Fees and the IWM Fund will forego approximately \$0.5 million in CSW AB 939 revenue in 1997-98 as shown in Table 4.

TABLE 4

**ESTIMATED 1997-98 FOREGONE REVENUE ABSENT A CHANGE
IN CSW FRANCHISE AND AB 939 FEES**

	CSW Franchise Fees	CSW AB 939 Fees	Total
Calculated 1997-98 CSW Franchise Fee and AB 939 Fee Revenue Objectives			
1996-97 Revenue Base Per 1996-97 Adopted Budget	\$7,875,000		\$7,875,000
Less 1.78% allowance for increased recycling in 1997-98	(140,175)		(140,175)
1997-98 Revenues Per Proposed 1997-98 Fees and Charges Report		7,240,000	7,240,000
Calculated 1997-98 revenue objectives	\$7,734,825	\$7,240,000	\$14,974,825
Projected 1997-98 Revenues*	\$6,332,922	\$6,735,538	\$13,068,460
Estimated Foregone 1997-98 Revenues	\$1,401,903	\$504,462	\$1,906,365
Rate Increase Required To Offset Estimated Foregone 1997-98 Revenues	+ 22%	+ 7%	+ 15%

* Projected net revenue for 1996-97 (from Table 3) less a 1.78 percent allowance for reduced volumes based on 1996-97 experience.

It should be noted that our calculated 1997-98 revenue objective of \$7,734,825 for CSW Franchise Fees is \$1,084,825 more than the \$6,650,000 shown in the 1997-98 Proposed Budget. Further, we estimate that current CSW Franchise Fee rates will only generate \$6,332,922 in 1997-98 or \$317,078 less than the budgeted amount of \$6,650,000. Thus, the \$1,401,903 in foregone 1997-98 CSW Franchise Fees shown above is the cumulative difference between (1) the amount necessary to maintain the 1996-97 CSW Franchise Fee revenue base and the CSW Franchise Fees proposed in the 1997-98 budget and (2) the CSW Franchise Fees proposed in the 1997-98 budget and projected 1997-98 CSW Franchise Fees as shown below.

– Difference between 1997-98 CSW Franchise Fees necessary to maintain the 1996-97 revenue base (\$7,734,825) and proposed CSW Franchise Fees in the 1997-98 budget (\$6,650,000)	\$1,084,825
– Difference between proposed CSW Franchise Fees in the 1997-98 budget (\$6,650,000) and projected 1997-98 CSW Franchise Fees (\$6,332,922)	<u>317,078</u>
Total Estimated Foregone CSW Franchise Fees In 1997-98	<u>\$1,401,903</u>

Suggested Method Of Recalculating The Proposed Rates Based On 1995-96 Rates

Revenue and volume information is currently available for 1995-96 and at least nine months of 1996-97. Our review revealed that the monthly activity reports that haulers submitted during 1995-96 included the data necessary to compile equivalent volumes of CSW. We have provided the ESD with our compilations of equivalent yardage for 1995-96 and 1996-97. The computation of equivalent volumes involves multiplying compacted trash by an equivalency factor of three, and converting reported tonnages to cubic yards for haulers that reported in tons. We suggest the ESD use the equivalent volume information to recalculate the franchise fee exclusion rate.

We also suggest the ESD recalculate the franchise fee rate by dividing the 1996-97 revenue objective by 1996-97 equivalent volumes. Similarly, we suggest the ESD recalculate the AB 939 rate by dividing the 1996-97 revenue objective by 1996-97 equivalent volumes.

Potential Recovery Of \$1.4 Million In 1996-97 Foregone General Fund Revenue

As shown above, we estimate that corrected rates would generate approximately \$15 million, or \$1.9 million more than could be expected absent a rate adjustment in 1997-98. However, these corrected rates would not make up for the estimated \$2.1 million in foregone

revenue during 1996-97. The City Attorney's Office has advised that CSW AB 939 fees cannot be retroactively applied. There is no such restriction on CSW Franchise Fees. Therefore, we recommend that the City Council also consider imposing:

- Full-recovery rates that recover the estimated \$1.4 million in foregone 1996-97 CSW franchise fee revenue to the General Fund or
- Partial-recovery rates that recover approximately \$1 million in foregone 1996-97 CSW franchise fee revenue (\$1,427,000 in foregone General Fund revenue net of the \$400,000 General Fund windfall).

Table 5 shows the cumulative total of these modifications.

TABLE 5
POTENTIAL REVENUE IMPACT OF MODIFICATIONS
TO 1997-98 CSW FEES

	CSW Franchise Fees	CSW AB 939 Fees	Total
Projected Impact of Modifications			
Potential recovery of foregone 1996-97 revenues	\$1,427,000		\$1,427,000
Potential additional 1997-98 revenues resulting from rate correction	1,402,000	\$504,000	1,906,000
Potential Additional 1997-98 Revenues	\$2,829,000	\$504,000	\$3,333,000

It should be noted that if the City Council does not adopt either of the above rate alternatives by July 1, 1997, the General Fund and the IWM Fund will forego at least \$117,000 and \$42,000 per month in revenues in 1997-98, respectively.

Potential Customer Impact Of Rate Correction

On May 22, 1997, the City Manager proposed to the City Council in Manager's Budget Addendum #4 that the ESD hire a consultant economist to analyze the impact of increasing CSW Franchise Fees and AB 939 Fees (see Appendix D). The ESD is concerned that a rate increase

could stimulate customer recycling (which is non-taxable) and thus actually reduce General Fund revenue by impacting landfill taxes and fees as well as CSW Franchise and AB 939 Fee revenues.

In addition to the CSW Franchise Fees that haulers pay, the General Fund receives Disposal Facility Taxes and Solid Waste Enforcement Fees from landfill operators. Based on our review of 1996-97 Disposal Facility Monthly Reports, we estimate that approximately \$2.9 million, or 15 percent of the \$19.3 million in taxes and fees that landfills pay to the General Fund is related to CSW franchise activity. Together with \$6.65 million in budgeted CSW Franchise Fees, we estimate that a total of \$9.5 million in General Fund revenue is directly related to CSW franchise activity. The estimated CSW Franchise Fee rate correction for 1997-98 is \$1.4 million or 15 percent of the \$9.5 million in total General Fund revenue that we estimate is directly related to CSW activity. Accordingly, the General Fund will see beneficial impact from a 1997-98 rate correction unless: (1) CSW activity declines by more than 15 percent because customers increase recycling as a result of the CSW rate correction, and (2) landfills are unable to make up the difference with solid waste from other jurisdictions.

Similarly, we estimate it would take a 7 percent decline in CSW activity (with no offsetting imports of solid waste to landfills from other jurisdictions) to have a negative impact on the \$7.4 million in IWM Fund revenues that are directly related to CSW franchise activity.

Furthermore, as Table 6 shows, we estimate that CSW diversion would have to increase by more than 11 percent as a result of a rate correction in order for that rate correction to have a negative impact on overall City revenues.

TABLE 6

**PROJECTED 1997-98 GENERAL FUND FRANCHISE
AND LANDFILL REVENUES ATTRIBUTABLE
TO THE COLLECTION AND DISPOSAL
OF COMMERCIAL SOLID WASTE**

	1997-98 Projected Revenues	Portion Attributable To CSW Franchises*
GENERAL FUND		
Haulers - CSW Franchise Fees**	\$ 6,650,000	\$ 6,650,000
Landfills - Disposal Facility Tax**	17,900,000	2,685,000
Landfills - Solid Waste Enforcement Fee**	1,405,000	210,750
Estimated General Fund revenue	25,955,000	9,545,750
Franchise Fee rate correction (from Table 4)	1,402,000	1,402,000
Correction as a percent of General Fund revenue	+ 5.4%	+14.7%
IWM FUND		
CSW AB 939 fees**	\$ 7,240,000	\$ 7,240,000
Landfill AB 939 fees**	810,000	121,500
Estimated IWM Fund revenue	8,050,000	7,361,500
AB 939 Fee rate correction (from Table 4)	504,000	504,000
Correction as a percent of IWM Fund revenue	+ 6.3%	+ 6.8%
TOTAL REVENUE IMPACT		
Total revenue	\$34,005,000	\$16,907,250
Total rate corrections	1,906,000	1,906,000
Correction as a percent of total revenue	+ 5.6%	+ 11.3%

* We estimate that only 15 percent of landfill taxes and fees are attributable to CSW activity.

** 1997-98 projected revenue from 1997-98 Proposed Operating Budget.

It should be noted that our estimate of the increased diversion needed to offset the increase in General Fund revenues a 22 percent CSW rate increase would generate, differs from the ESD's. Specifically, ESD staff estimate that 23 percent of the taxes and fees that landfills pay to the General Fund are related to CSW franchise activity as opposed to our estimate of 15 percent. The difference in our estimates lies in ESD's assumption that **none** of the CSW that San Jose businesses generate and is subsequently hauled to a San Jose landfill is

diverted to a non-taxable use. ESD makes this assumption in spite of the fact that San Jose landfills divert about 38 percent of incoming tons of material from all jurisdictions, including San Jose, to non-taxable uses.¹ Conversely, we assume that landfill operators have and will continue to divert incoming San Jose CSW to non-taxable uses at the same rate as all other jurisdictions.² It should also be noted that using IWM's zero percent diversion assumption only changes our estimate of the percentage increase in CSW diversion needed to offset the additional General Fund revenues a 22 percent CSW rate increase would generate from 15 percent to 13 percent.

In addition, to the extent that franchise and AB 939 fees are only a portion of a CSW franchise customer's bill, a percentage increase in these fees will have a smaller proportional impact on the customer's total bill and be less likely to affect customer recycling behavior. For example, we estimate that in 1995-96, haulers charged their customers an average base price of \$5.04 per cubic yard.³ Using this average base price, we estimate that even if CSW haulers pass all of the 22 percent increase in CSW Franchise Fees and 7 percent increase in CSW AB 939 Fees (as described on page 14) directly on to their customers, the average customer's bill would increase by less than 6 percent as shown below:

¹ For the first nine months of 1996-97, landfills categorized 639,000 tons as non-taxable out of a total of 1,662,000 incoming tons reported on their Disposal Facility Monthly Reports.

² Except for incoming Recycle Plus yardwaste which we assume is entirely diverted

³ Based on 1995-96 CSW Monthly Remittance Reports which show \$21,250,497 in reported gross receipts (net of franchise fees) for 4,216,814 cubic yards. It should be noted that because of quantity discounts, the actual customer price per yard is usually higher for smaller quantities than for larger quantities.

	1995-96 Average CSW Charge	Estimated Fee Increases	Revised Average CSW Charge	Rate Increases
Customer base price per cubic yard	\$5.04		\$5.04	
CSW Franchise Fee	1.64	\$0.36	2.00	22.0%
CSW AB 939 Fee	1.77	0.12	1.89	7.0%
Price per cubic yard	\$8.45	\$0.48	\$8.93	5.7%

Finally, the ESD has consistently warned the City Council that as county-wide diversion increases over the long term, Solid Waste and Landfill fees will decline. For example, the equivalent volumes that CSW franchisees hauled between 1995-96 and 1996-97 declined by 2 percent. Since the City is under a State of California mandate to increase diversion to 50 percent by the year 2000, increased diversion is a positive outcome. In our opinion, a rate correction is appropriate and will benefit the City from an economic and environmental standpoint.

CONCLUSION

The July 1996 revised CSW franchise and AB 939 volume-based fee rates were miscalculated. As a result, we estimate that the City has foregone \$2.1 million in revenue during 1996-97. This shortfall has been partially offset by a one-time windfall of \$1.5 million due to a change in the timing of when CSW activities are subject to fees. In keeping with the original intention that the revised rates maintain the revenue base, we recommend that ESD and the Budget Office propose revised 1997-98 rates. We estimate that needed modifications to these fees would increase General Fund revenue by \$1.4 million and IWM Fund revenue by \$0.5 million. Furthermore, the City Council should consider whether to implement full- or partial-recovery fees to recover the \$1.4 million in foregone 1996-97 General Fund revenue. As a result of these changes, we estimate that the General Fund could realize from \$1.4 million to \$2.8 million, and the IWM Fund could realize \$0.5 million.

RECOMMENDATION

We recommend that ESD and the Budget Office:

Recommendation #1:

Propose 1997-98 commercial solid waste franchise fees and commercial source reduction and recycling fees that will maintain the revenue base with regards to franchise fees and produce the amount of revenue shown in the 1997-98 Fees and Charges Report. Also propose partial- and/or full-recovery rates to recover foregone 1996-97 franchise fee revenue. (Priority 2)